Energy

A stable and secure energy supply is an essential requirement for a successful modern economy. Although California's energy supply has proved adequate for the past year, the severe shortages and high electricity prices of 2001 are not far behind us. Moreover, price stability has resulted primarily from the slowing of the State's economy rather than from positive actions by the State's policy makers.

Much of California's energy uncertainty began with the implementation of electricity restructuring. In 1996, California enacted Chapter 854, Statutes of 1996 (AB 1890), which began the transition from a highly regulated utility environment to a relatively open and free market. The restructuring was intended to promote competition in the electric industry, which in turn was to reduce prices for consumers and businesses. While the theory was good, its implementation under this Chapter proved disastrous. Today, the following implementation errors are generally agreed to have undermined what could have been a successful program:

- Mandatory divestiture of power plants. This contributed to insufficient electricity generation capacity, and allowed generators to game the market in 2001.

- Prohibition of long-term contracts, and the corresponding requirement that all power be purchased in the spot market.

- Policies that allowed stranded costs to be recaptured by utilities too rapidly, thereby putting upward pressure on prices.

- An unreasonably low target price that prevented potential new generators from entering California's power market.

- Failure to create demand-side infrastructure that would allow customers to respond to price spikes by reducing demand.

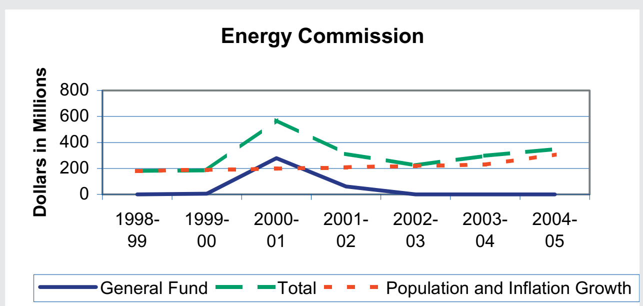
These mistakes undermined the reliability of California's electricity system. The wholesale power market established in California did not attract new suppliers because of its very low target price. The serious drought in California and the Northwest significantly reduced hydropower resources in 2001. Divestiture prevented utilities from meeting their owns needs. Few demand-side options were available to quickly reduce demand. These factors allowed independent generators to manipulate the market, raising prices to extraordinarily high levels. Ultimately, California's major utilities were driven close to insolvency and the State was forced to purchase power on their behalf. Even with its enormous purchasing power, and its ability to enter into long-term contracts, the State was unable to return electricity prices to the levels they had been before the crisis.

The energy crisis greatly damaged Californians. Few individuals or businesses were spared the consequences of power outages, higher energy prices, business failures, and utility bankruptcies. Most damaging is the paralysis that has set in among California's energy policy makers, whose apparent fear of repeating the crisis of 2001 has prevented them from taking effective action to promote energy security. Nevertheless, it is precisely this inaction that makes possible the recurrence of energy shortfalls.

In an effort to learn from past mistakes and move forward, the Administration's energy plan will pursue a strategy that involves the following actions:

- Create a uniform State strategy to stimulate private investment in our energy markets and align the State's energy agencies to support that strategy.
- Create a working wholesale power market based on the lessons learned from the crisis, other states, and the Federal Energy Regulatory Commission's standard market design.
- Assure adequate and diverse fuel for power generation.
- Encourage cost-effective conservation by increasing demand response to changing electricity markets.
- Enact electricity reserve requirements for power generators.

Key Audit Findings—California Energy Commission



- Legislation enacted in response to the energy crisis provided $306 million in one-time General Fund in 2000-01. These funds were used to implement various energy conservation and efficiency projects. Since that time, no General Fund has been appropriated for Energy Commission programs.
- The two energy development programs that constitute much of the Commission's work are not supported by the General Fund. They include: (1) the Public Interest Energy Research program, which funds energy-related research, development, and demonstration projects such as research to reduce energy use, improve electric system reliability, and improve air quality, and (2) the Renewable Energy Program, which provides subsidies to existing, new, and emerging energy technologies, including solar, geothermal, and small landfill gas energy generation projects. Both of these programs are funded by a surcharge on energy utility bills that totals $197.5 million annually.

Currently, many State departments have energy-related responsibilities. The most prominent are the California Energy Commission, the Public Utilities Commission (PUC), the California Power Authority, and the Electricity Oversight Board.

California Energy Commission

Functions of the California Energy Commission

The mission of the California Energy Commission is to ensure a reliable supply of energy that meets California's needs and complies with environmental, safety, and land use goals. The Commission processes applications to site new power facilities, encourages measures to reduce wasteful and inefficient use of energy, and monitors alternative ways to conserve, generate, and supply energy. The Budget proposes $356 million and 456 personnel years for state operations and local assistance.

Public Utilities Commission

Functions of the Public Utilities Commission

The PUC is responsible for the regulation of investor-owned utilities, including gas, electricity, telephone, water, railroads, and certain passenger and household goods carriers to ensure the delivery of stable, safe, and economic services. Specific activities include enforcement of safety regulations, regulation of rates for services, and promotion of energy and resource conservation. The Budget proposes $1.2 billion and 834 personnel years for state operations, including $857 million for the telecommunications programs and $246 million for the natural gas programs.

Electricity Oversight Board

Functions of the Electricity Oversight Board

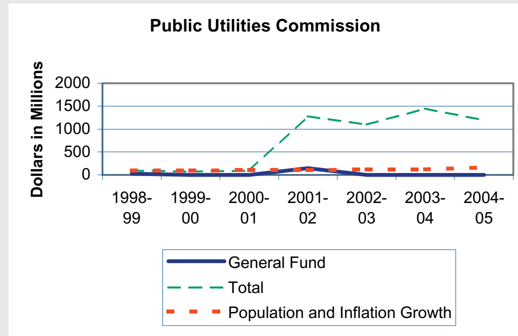
The Electricity Oversight Board is responsible for overseeing the operation and reliability of the electricity transmission system; the operation, efficiency, and competitiveness of markets for bulk energy, transmission, ancillary services; and all activities of the Independent System Operator. The Budget proposes $3.6 million and 22 personnel years for state operations.

California Power Authority

Functions of the California Power Authority

The purpose of the California Consumer Power and Conservation Financing Authority (Authority) is to help ensure that California has a sufficient supply of electricity at reasonable prices by promoting access of new projects to capital. Activities include promoting conservation, financing new projects, and advancing greater use of renewable energy. In spite of these responsibilities, the Authority has had limited success. It has not achieved financial self-sufficiency, nor does it appear that it will in the near future. Other State energy agencies and private entities already perform similar activities.

Key Audit Findings— Public Utilities Commission



- In 2003-04, the PUC's budget includes $1.446 billion in total funds and no General Fund. This is an increase in total funds of $1.35 billion (1,405 percent) since 1998-99.
- General Fund expenditures rose from $28 million in 1998-99 to $148.2 million in 2000-01 and dropped to none in 2003-04. These changes are mainly attributed to enactment of Chapter 7, Statutes of 2001, First Extraordinary Session (SB 5X), which provided approximately $150 million one-time funds during the energy crisis to subsidize consumer electricity bills and purchase energy-efficient lighting and appliances.
- In the 2003-04 PUC budget, $70 million supports the staff that performs Commission activities. The balance is used for contracts and reimbursements that promote telecommunications and natural gas public purpose programs. This is an increase of $1.18 billion (or 1,121 percent) above the 1998-99 budget. These increases are due to a shift of existing telecommunications and natural gas public programs and funds from the utilities to the PUC. The telecommunications programs subsidize high-cost telephone operations, reduce telephone charges to low-income persons, and provide special telephone equipment to the deaf and disabled. The natural gas programs subsidize consumer electricity bills and help customers purchase energy efficient lighting, appliances, and other equipment. These programs may warrant further examination for possible reduction or elimination, which would then result in reduced rates paid by utility customers.
- The Budget Act of 2002 transferred a combined $278.1 million from the California High Cost Fund A and B funds to the General Fund. In addition, the Budget Act of 2003 loaned $150 million from the California Teleconnect Fund to the General Fund.